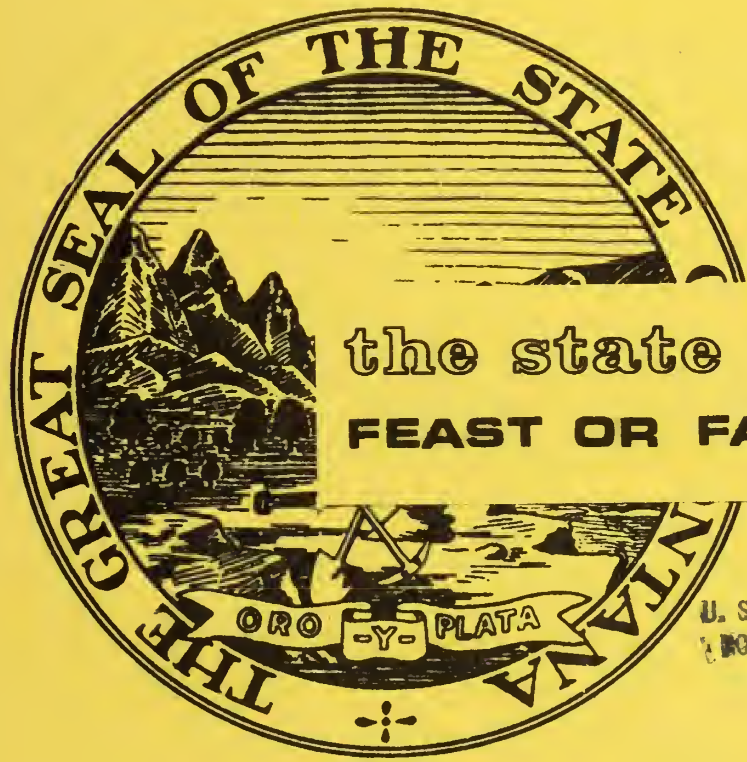
a WHITE PAPER report

TO GOVERNOR THOMAS L. JUDGE



the state GENERAL FUND:
FEAST OR FAMINE?

PREPARED BY THE
Department of Administration
FINANCE DIVISION

STATE OF MONTANA

DEPARTMENT OF ADMINISTRATION

HELENA 59601

September 10, 1973

The Honorable Thomas L. Judge
Governor of Montana
State Capitol
Helena, Montana 59601

Dear Governor Judge:

Based on our five-year projection of the General Fund, we urge extreme caution be used in advocating or approving new or expanded programs. Undoubtedly this word of caution seems unnecessary when Montana has just realized the biggest year-end surplus in recent history. Montana State government faces many financial contingencies within the next five years. If adequate provisions are not made now to provide for future demands on the General Fund, a tax increase will be inevitable within your current term of office.

Montana's economic paradox is being produced by a combination of: inflationary pressures; unstable economy; uncertainty of Federal Revenue Sharing; increased pressure for higher employee salaries and fringe benefits; and the impact of the recently reduced income surtax.

To offset these contingencies, we recommend that a portion of the General Fund surplus be set aside to meet future program commitments, and that recurring spending programs be severely limited insofar as is practicable. If program costs are restricted and part of the present General Fund surplus is carried forward, we believe you can submit an adequate budget to the 1977 Legislature without requesting any new taxes.

The accompanying report, prepared by our Finance Division, analyzes the various financial contingencies Montana faces. I recommend that it be carefully reviewed by you and your staff as soon as possible. After needed additions or deletions are made, I further recommend that it be distributed to interested parties throughout the State.

Sincerely,

Doyle B. Saxby

Doyle B. Saxby
Director

DBS:bc

ANALYSIS AND PROJECTION OF THE GENERAL FUND'S FINANCIAL CONDITION: Questions and Answers.

INTRODUCTION

The financial stability of the General Fund is of importance to every Montanan. Through the General Fund, many important governmental services are provided to the general public for which the taxpayer and consumer pays in the form of direct taxes, indirect taxes, licenses, fees and permits.

The General Fund, as previously announced, presently appears to be in a very healthy financial condition despite the fact that a portion of a major tax base (the income surtax) was reduced effective January 1, 1973. Just how "healthy" the General Fund is depends upon a relatively long-range projection of future financial activities.

In today's economic climate, combined with soon to be remedied weaknesses in our available data bases, it is difficult to forecast the future. Even so, a forecast must be made.

In making the analysis included in this report, the concern of Montana's taxpayers has been held foremost in mind. We acknowledge the validity of the assertion that government should not extract more from its taxpayers than is necessary to provide an adequate level of governmental services. On the other hand, we doubt that the average taxpayer is especially fond of a tax base that fluctuates from year to year.

The necessary analysis of the General Fund's financial future tends to be complex. In an attempt to penetrate the veil of complexity, the analysis which follows is arranged on a question and answer basis. In so doing, we hope that all major questions have been asked and a reasonable, objective answer has been provided for each.

SUMMARY

As of June 30, 1973, the General Fund surplus amounted to $18.2 million. An additional $6.8 million should be added to surplus by June 30, 1975 (for a total of $25.0 million) if the following assumptions hold true:

1. Presently existing inflationary pressures continue at a rate of about five percent per year.

2. Montana's prospering agricultural industry does not recess.

3. No substantial supplements to the 1973-75 biennium budget are authorized by the second session of the Forty-Third Legislative Assembly.

4. No substantial reduction in the base of General Fund revenue sources is enacted by the second session of the Forty-Third Legislative Assembly

5. The Coal Production Tax produces around $5.0 million annually.

Although the General Fund does indeed have more financial resources than were acknowledged at the time the 73-75 budget was adopted, considerable care must be exercised in developing disposition plans. Many contingencies lie ahead in Montana's financial future. Provisions must be made to meet these contingencies if the present administration desires and intends not to increase the tax base of General Fund revenue sources over the next five years (through the 1978-79 fiscal year).

Some of the contingencies we have considered are summarized below:

FLUCTUATIONS IN THE GENERAL ECONOMY: Most business advisors predict continued inflation; some hope for stabilization; a few warn of a recession. Any one of these alternatives has an impact on the State's General Fund.

PRACTICABILITY OF THE 1973-75 BIENNIUM BUDGET: If inflationary factors continue, the spending level set for the 1974-75 budget, which increased "base" programs only one percent over the 1973-74 level, may not be sufficient if the established level of governmental services is to be maintained.

PRESSURES TO RAISE SALARIES: Employee Collective Bargaining; the Statewide Classification and Pay Plan; the Federal Minimum Wage Act; and general inflation will tend to increase salaries over the next five years. While we can probably finance a general five percent increase per year, anything more than that becomes a financial problem. The Classification and Pay Plan could, by itself, amount to $3 to $5 million annually for a four-year total of from $12 to $20 million.

INCREASING EMPLOYER PAYROLL COSTS: All employer payroll costs are scheduled to increase over the next five years. The four-year price tag, beginning with the 1975-76 fiscal year, is around $4.8 million.

DISCONTINUANCE OF REVENUE SHARING: Although Federal officials have not even suggested that general Revenue Sharing will not be renewed beyond the December 31, 1976 termination date now set, most state officials believe this to be a real possibility. We are now using $18.5 million in the 1975 biennium of Revenue Sharing monies to finance recurring expenditures otherwise financed from the General Fund. Discontinuance of Revenue Sharing would undoubtedly necessitate an increase in the income surtax as of January 1977 unless a surplus has been reserved to meet this major contingency.

NON-FUNDED FEDERAL PROGRAMS: With Revenue Sharing, several Federal programs financed by categorical grants are being reduced or will be discontinued. If it is considered necessary to continue these programs, alternate neans of financing them must be provided. More than likely, the General Fund will be called upon for this purpose.

CASH BASIS BUILDING PROGRAM: Depending on the level of construction effort authorized, $11.0 million could be required through the 1977-79 biennium to put the building program on a cash basis. Unless a new source of revenue is provided, the necessary cash financing will have to come from the General Fund.

LOSS OF INVESTMENT POWER: Each one million dollars held as surplus can produce $80,000 annually in interest depending on prevailing rates. Providing for a continuing surplus could produce substantial revenue for the General Fund which diminishes the need for tax increases.

In providing a financial plan for the General Fund, projecting needs and resources through fiscal 1979, we advocate the following three-point plan:

1. CONTINGENCY RESERVE

Provide, within the General Fund, a $10.0 million contingency reserve which is to be used only after all reasonable alternatives have been exhausted. And, further providing, that drawdowns be replenished as soon as possible if to do so does not necessitate an increase in the base of major General Fund revenue sources.

2. CONSIDER BUDGET SUPPLEMENTS

Budget supplements to the 1973-75 biennium budgets, wherein an augmentation is clearly justified or produces significant, desirable results, should be considered. To assure financing in future years without using the recommended contingency reserve, supplements should not exceed the following maximums:

All supplements effective 1-4-74	$1.04 million
All supplements effective 7-1-74	$1.34 million.

If the total projected surplus of $25.0 million is used, these two limitations can be increased to $2.7 and $3.2 million respectively. (One million has already been set aside for supplements in the 1974-75 fiscal year).

3. STABILIZE THE TAX BASE

Although government should not extract more dollars from its taxpayers than is necessary to conduct desirable governmental programs, we cannot advocate a reduction in the tax base of any General Fund revenue source at this time. In light of future expenditure demands, a major reduction in, for example, the income surtax at this time, would undoubtedly necessitate a tax increase the following year. Instead of a fluctuating tax base, we advocate a stable one even though by so doing temporary surpluses are produced.

In the accompanying analysis, we have attempted to present a very thorough analysis of the General Fund's financial condition. In so doing, we have expanded upon the material included in this summary. We hope that the material will be useful to all concerned in understanding our viewpoints regarding the financial future of the General Fund.

QUESTIONS AND ANSWERS

WHAT IS THE GENERAL FUND'S FINANCIAL CONDITION AS OF JUNE 30, 1973?

As of June 30, 1973, the General Fund's financial records report assets of $26.15 million and liabilities of $1.99 million. The $24.16 million difference between assets and liabilities is divided into three parts:

Reserve for Continuing Appropriations	$ 4.64 Million
Reserve for Automatic Statutory Appropriations	1.30 Million [1]
Fund Balance — General	18.22 Million
Total	$24.16

"Fund Balance — General" can, as a rule of thumb, be referred to as "surplus". Accordingly, an unqualified statement would acknowledge General Fund surplus at June 30, 1973 as $18.2 million.

Although a point in time surplus of $18.2 million is acknowledged, one must not assume that that amount of money is available for whatever purpose desired. An analysis must first be made to:

- o Determine the general trend of future financial activities; and
- o Determine what specific impact that financial plan, designed in essence to reduce surplus, will have over a long-range period of time.

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(1) Not formally recorded in the general ledger as of June 30, 1973 (Plant Utility Siting Fees).

WHAT MAJOR FACTORS PRODUCED THE SURPLUS?

The General Fund Surplus as of June 30, 1973, is $10.2 million higher than anticipated on January 1, 1973 and $8.9 million higher than anticipated on April 2, 1973. The unanticipated difference is due largely to greater revenue/income collections than estimated.

Referencing an analysis made by the Department of Revenue(2):

- o State General Fund collections for fiscal year 1973 exceeded anticipated collections by approximately 10 percent. Total collections for FY 1973 amounted to $112.6 million, compared to the estimated $102.2 million.
- o The chief contributor to the excess of actual collections over expected collections was the personal income tax, which produced nearly $8.0 million more than estimated.
- o Earnings on investment amounted to $3.4 million; more than twice the $1.6 million estimated.
- o Reimbursements to public institutions were almost 50 percent more than estimated (producing an extra $.9 million).

Several other General Fund sources of revenue exceeded the amount estimated and several were less than anticipated--notably liquor profits which, because of a temporary, cash flow, problem, were down $1.75 million.

In our opinion, and excepting some portion of income from the agricultural industry, the unanticipated extra revenue has resulted largely from inflationary pressures rather than economic growth. We attribute only a small portion of the increased revenue to new industry, increased population, or greater productivity or improved profit margins within existing industries. A greater percentage of Montana's population, however, appears to be gainfully employed in recent years.

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(2) Keith L. Colbo, Director of the Department of Revenue to Members of the Montana Senate and House, July 13, 1973, "General Fund Revenue Collections — Fiscal Year 1973".

THE UNENCUMBERED GENERAL FUND SURPLUS HAS PREVIOUSLY BEEN ANNOUNCED AS $10.0 MILLION. IS THE CORRECT FIGURE $18.2 MILLION OR $10.0 MILLION?

In governmental accounting, surplus may be defined as: that amount by which current assets exceeds current liabilities. To a governmental manager, surplus means: that amount which is in excess of all known needs or demands.

In developing a long-range financial plan, the latter definition must be employed. To do otherwise could result in consumption of the "surplus" in one year with a resultant revenue—expenditure deficit in future years. In government, this condition would necessitate either a restriction in programs or an increase in the base of applicable revenue source (taxes).

The $10.0 million surplus figure was derived starting with an $18.2 million base and subtracting from that the amount by which appropriations and reserves exceed initial revenue estimates over the next two years:

	MILLIONS	
Surplus: June 30, 1973		$ 18.2
1973-74		
Estimated Revenue	$ 105.6	
Net Appropriations & Reserves	111.4	
Deduction from Surplus		-5.8
1974-75		
Estimated Revenue	$ 114.8	
Net Appropriations & Reserves	117.1	
Deduction from Surplus		-2.3
Unencumbered Surplus: June 30, 1975		$ 10.1

To answer the question: $18.2 million is the correct base from which to begin. The reduction of the present surplus to consider funding needs of future years is the central issue of this report.

WHAT IS THE NATIONWIDE FINANCIAL TREND AT THE STATE LEVEL?

At the recent meeting of the National Association of State Budget Officers (NASBO), we inquired of the some 46 states represented whether or not their state was enjoying an unanticipated surplus and to what use that surplus, if any, was to be put. The relatively unstructured answers to our question indicated that most states have a greater general fund surplus than anticipated and most states, from the budget officer level at least, plan to regard the surplus as only a temporary windfall at this point in time. From other discussions, it appears that this posture is justified considering the uncertainty of national economic conditions which have a decided impact on most state general funds.

IN DEVELOPING A FINANCIAL PLAN, HOW FAR SHOULD WE LOOK AHEAD?

In this analysis, we will project, as well as can be expected, through the 1978-79 fiscal year. This projection period was selected because it embodies the last year of the last biennial budget to be submitted by Governor Judge within his current term in office.

We would like to extend the projection even further, but a projection through 1978-79 is, in itself, based on many unknown factors.

IN DEVELOPING A FINANCIAL PLAN, WHAT BASIC ASSUMPTIONS HAVE BEEN MADE?

In formulating our recommendations regarding the financial plan for the General Fund, we have assumed that the following conditions and objectives are necessary and/or desirable:

o The governor is, by virtue of Article VIII, Sections 8 and 9 of the State Constitution, obligated to submit a balanced budget to the Legislature and, in fact, desires to submit a balanced budget--constitutional provisions notwithstanding. (A "balanced budget" is one that does not require deficit financing.).

o If at all possible, future budgets through the 1978-79 fiscal year should not necessitate a major increase in the tax base of a major General Fund revenue source. If practicable, the budget plan should provide for a tax reduction.

o The General Fund budget plan should operate from a relatively stable tax base rather then one that fluctuates from year to year (i.e., reduce the tax base one year with a planned increase in the next year).

GENERALLY SPEAKING, HOW DOES MONTANA'S FINANCIAL FUTURE LOOK?

The unmodified 1973-75 biennium budget plan anticipates that through this biennium net authorized expenditures plus reserves will exceed revenue:

(MILLIONS OF DOLLARS)

	Estimated Revenue	Net Appropriations Plus Reserves	Estimated Deduction From Surplus
1973-74	$105.6	$111.4	$ 5.8
1974-75	114.8	117.1	2.3
Total	$220.4	$228.5	$ 8.1

Based on the fact that 1972-73 fiscal year General Fund revenue totaled $112.6 million, we do not believe that it is satisfactory to use these revenue figures. Instead, we advocate use of the following revenue projections:

1973-74	$113.5
1974-75	121.8

If these revenue projections are accurate, revenue will exceed net authorized expenditures plus reserves in both years of the present biennium adding $2.1 million and $4.7 million to surplus respectively.

The accuracy of these forecasts depends on several variables:

1. The income surtax that helped produce the 1972-73 surplus has been reduced from 40 to 10 percent. 1972-73 was the last year in which the 40 percent surtax will have any material impact. Hence, a reduction of income tax revenues must be anticipated.

2. Generally speaking, we believe that inflationary pressures will continue at a rate of around five percent through the 1973-75 biennium. Increased wages and profits upon which the income tax is based should offset the reduction in the income surtax somewhat.

3. The coal production tax has been increased to finance the General Fund spending plan. Estimates of added revenue vary. Collections of around $5.0 million annually are needed to attain the updated revenue estimates.

4. The 1973-75 biennium budget, especially the 1974-75 fiscal year portion, is relatively austere. From the 1972-73 fiscal year expenditure base of $97.3 million (and excluding the new programs and increased Foundation Program funding included in Governor Judge's supplement), 1973-74 fiscal year expenditures represent an increase of about 7 percent. From the same base, 1974-75 fiscal year expenditures represent an increase of about eight percent--one percent increase from 1973-74 to 1974-75. This follows a five year increase average of about ten percent (beginning with the 1969-70 increase and including the 1973-74 increase).

Whether or not the 1974-75 fiscal budget can be considered a practicable one in light of unanticipated inflationary pressures is an important consideration. Already, it appears that the Emergency and Disaster Program will have to be replenished.

5. The Legislature, in its 1974 session, has the opportunity to authorize additional spending plans. The magnitude of these plans could diminish the amount of the projected surplus.

Beyond the 1973-75 biennium, we are reluctant to project additional contributions to the General Fund surplus. We anticipate, however, that revenue will at least equal authorized expenditure plans providing that the expenditure plan does not exceed a five percent increase over the $117.1 expenditure level presently authorized for the 1974-75 fiscal year.

There are, however, many contingencies that lie ahead in Montana's financial future. These contingencies may make it virtually impossible to limit the increase in the State's General Fund spending plan to five percent annually. If these contingencies become reality, which some will, it will be necessary to depend upon the accumulated surplus to finance the difference. Just how much of the surplus should be reserved for this purpose is the question we are trying to answer.

With regard to governmental expenditures, we will acknowledge that spending has a tendency to expand to utilize all available revenue. We must, obviously, be ever cautious to authorize only those new programs or program expansions that are clearly justified--despite the amount of available revenue.

In an inflationary economic environment, we see the following posibilities with regard to expenditures:

o If the price of commodities purchased by the State increase, we have one of two choices: Increase the level of expenditure; or reduce the quantity or quality of items purchased. The first choice tends to increase taxes; the second choice tends to lessen the quality and quantity of governmental services provided.

o As far as salaries and wages are concerned, we have three choices: Limit or reduce the number of employees on the payroll; hold the line on salary increases; or increase salaries to make them compatible with those paid in private enterprise. The first option tends again to degrade the quality and quantity of governmental services; the second option tends to penalize the State employees requiring them to finance the cost of State government; the third option tends to increase taxes.

In summary, we firmly believe that unless future General Fund financial plans are prudently formulated--especially those expenditure plans that involve the use of the present surplus--it will be necessary to increase the base of present General Fund revenue sources and/or to provide for new General Fund revenue sources within a relatively short period of time.

IF WE KNEW NOW THAT FUTURE YEARS WOULD PRODUCE A SURPLUS, DIFFERENT PLANS COULD BE FORMULATED AT THIS TIME. WHY CAN'T MORE DEFINITIVE PROJECTIONS BE MADE?

Quite typically government financial plans simultaneously consider both necessary and/or desirable expenditure plans and revenue sources available to support the expenditure plan under consideration. In some cases, expenditures are reduced to coincide with available revenue. In other instances, revenue is increased as required to support the adopted expenditure plan. In the end result, however, the adopted expenditure plan is largely dependent upon available revenue.

Any projection of the General Fund surplus is highly dependent upon the accuracy of revenue estimates. Revenue estimates are, in turn, highly dependent upon National and State economics. If inflationary trends continue, both salaries and wages paid in the private sector will continue to increase and profits will continue to grow in terms of magnitude (without a percentage growth). Both of these factors would increase revenue to the General Fund (and the other entities sharing income and corporate license taxes).

At this time, a revenue projection must consider the reduction in the income surtax from 40 to 10 percent; the amount of revenue to be derived from the coal production tax; and, certainly, the possibility of continued inflation, a leveling off, or even a period of recession. In the latter regard, the opinion of National economists vary. Some see continued inflation; others predict a recession; some simply don't seem to know.

A Columbia University Professor[3] says that the ". . .economy's momentum is already lessening. . .", ". . .In short, a moderation of the economy is returning to a slower but sustainable rate of growth, with less inflation. . ."

In summary, economic conditions beyond our control prohibit an accurate, long-range projection of anticipated revenue. The same economic instability and other contingencies place similar restrictions on predictions of future expenditure plans.

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(3) The MGIC Newsletter, July/1973, The Economic Outlook: Midyear 1973 by Raymond Saulnier, Professor Emeritus of Economics Barnard College, Columbia University.

WHAT MAJOR CONSIDERATIONS HAVE BEEN ACKNOWLEDGED IN RECOMMENDING A FINANCIAL PLAN FOR THE GENERAL FUND?

In developing a financial plan for the General Fund, consideration must be given in three major areas (details follow):

	Millions of Dollars Involved	Page
1. Projecting Adopted Expenditure Plans	Non-Monetary	
2. Loss of Investment Power	$ 8.6 *	
3. Contingencies:		
A. Discontinuance of Federal Revenue Sharing	$ 19.0 **	
B. Employee Salaries	$ 3.5 ***	
C. Non-Funded Categorical Federal Programs	Unknown	
D. Increased Employer Payroll Costs	$ 4.9 ****	
4. Cash Basis Building Program	$ 11.0 *****	

* Projected over a five-year period
** 1977-79 biennium only
*** One-year figure only--possibly effective 7-1-75
**** Four-year total beginning 7-1-75
***** 1975-77 and 1977-79 bienniums

1. PROJECTING ADOPTED EXPENDITURE PLANS

As of June 30, 1973, a surplus of $18.2 million is available for disposition. If our projections are accurate, Fiscal 1974 will produce an additional $2.1 million and Fiscal 1975 will produce an additional $4.7 million. Providing that in the remaining three years revenue will closely equal adopted expenditure plans, a multi-year projection must be made to assure that whatever additional recurring expenditure plans are formulated can be financed at least through the 1978-79 fiscal year.

Generally speaking, non-recurring expenditures plans have no long-range direct financial impact upon future General Fund operations. In other words, once the money has been spent, there is no further demands upon future budgets. (In providing for non-recurring dispositions, consideration must be given to the loss of interest and the reserve for contingencies problems.)

Recurring expenditure plans, on the other hand, have long-range financial impact. To determine the feasibility of adopted plans, it is necessary to first determine the amount of the available surplus by deducting non-recurring expenditure plans and dividing the remainder by the number of years from the effective date of the plan through Fiscal 1979:

Effective Date	Divisor
1-1-74	5.5
7-1-74	5
7-1-75	4
7-1-76	3
7-1-77	2
7-1-78	1

For recurring expenditure plans beginning July 1, 1974, a financing projection can be determined by dividing the total accumulated surplus (through June 30, 1975) of $25.0 million by 5: $\frac{\$25.0}{5}$ = $5.0 million maximum recurring expenditure plan. Reducing the total by increments of $1.0 million produces the following maximum recurring expenditure plan considering a July 1, 1974 effective date:

Total Amount Available	Maximum Recurring Expenditures	Total Amount Available	Maximum Recurring Expenditures
$ 25	$ 5.0	$ 12	$ 2.4
24	4.8	11	2.2
23	4.6	10	2.0
22	4.4	9	1.8
21	4.2	8	1.6
20	4.0	7	1.4
19	3.8	6	1.2
18	3.6	5	1.0
17	3.4	4	.8
16	3.2	3	.6
15	3.0	2	.4
14	2.8	1	.2
13	2.6		

Applying the formula, for example, if $10.0 million of the surplus were to be set aside as a contingent reserve and $4.0 million were to be appropriated for non-recurring expenditures (building project, for example), $11.0 million would remain for recurring expenditures. The maximum one-year plan would be $2.0 million.

2. LOSS OF INVESTMENT POWER

Any cash reduction of General Fund surplus reduces potential investment earnings to the General Fund thereby reducing General Fund revenue.

All available cash is presently considered in making investment decisions -- not just General Fund surplus. It can be accurately stated, however, that an $18.2 million dollar surplus adds to the interest earnings credited to the General Fund. In round numbers, each $1,000,000 carried in surplus earns $80,000 annually[4]. Over the next five years, $18.2 million could earn $8.6 million in interest[4].

We believe that the loss of interest earned on the surplus is of significant importance. This substantial amount would, obviously, increase the probability of achieving the objective of not increasing the base of General Fund revenue sources over the next five years -- and for future years as well.

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(4) Eight percent compounded semi-annually.

3. CONTINGENCIES

Several contingencies with significant impact lie ahead in Montana's financial future. Even though the precise "price tag" associated with these contingencies is yet unknown, their existence must be acknowledged. Those analyzed in this report are listed by subject:

A. Discontinuance of Revenue Sharing

B. Employee Salaries

1. Employee Collective Bargaining Act
2. Uniform Classification and Pay Plan
3. Federal Minimum Wage Act

C. Non-Funded Categorical Federal Programs

D. Increased Employer Payroll Costs[5]

1. Social Security
2. Employee Reitrement
3. Unemployment Insurance

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(5) Workmen's Compensation insurance costs have increased beyond those anticipated in the 1973-75 biennium budget and are likely to continue to increase over the next five years as necessary to finance added benefits. Also, travel expense allowances were increased as of July 1, 1973. These two factors have an impact on the General Fund budget but can be handled, in our opinion, without a budget supplement through the 1973-75 biennium.

A. DISCONTINUANCE OF REVENUE SHARING

There is no question in our minds that Federal Revenue Sharing money has lessened the General Fund's financial burden and at the same time, has both made the funding of additional programs possible and permitted the expansion of existing programs (notably the school foundation and kindergarten programs). At this time, revenue sharing receipts are estimated as follows:

Fiscal Year	Millions	
1972-73	$ 8.94	(Actual)
1973-74	8.06	
1974-75	7.97	
1975-76	8.18	
1976-77	6.30	
FIVE YEAR TOTAL	$39.65 [6]	

In the 1973-75 biennium, $18.5 million of Revenue Sharing funds has been appropriated for continuing operations of the Institutions. In the next biennium, a maximum of only $14.0 million is appropriated for Institutional operations, $4.5 million must be financed from the General Fund to maintain the same level of funding.

This $4.5 million can be financed from accumulated surpluses or provided for by reduced support of the Foundation Program -- which must then be made up by the counties. If a portion of Revenue Sharing funds is appropriated for building purposes, the financing problem would become greater.

If the revenue sharing program is discontinued, biennial expenditures of about $14.5 [7] million will, more than likely, have to be financed from the General Fund. With no appreciable surplus at that time, taxes would probably have to be increased in the 1977-79 biennium. A surplus of $14.5 million would, obviously, be necessary to hold off a tax increase through the 1977-79 biennium.

While the Federal Government has not even suggested that the Revenue Sharing Program will not be renewed beyond the December 31, 1976 termination date now provided, we believe, nevertheless, that this is a real possibility. This premonition is expressed in an August 2, 1973 "Report to Congress" prepared by the Comptroller General of the United States.

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(6) $5.9 million has been appropriated for capital outlay purposes to date.

(7) Anticipated level of funding in the 1975-77 biennium.

> ". . . restrictions on the use of revenue sharing funds and concern over discontinuation of the program definitely affected (state) decisions on how to use the funds."

As of the report date, the various states had formulated definitive plans to utilize $840.6 million of the total amount provided. In so doing, only sixteen percent of that amount was used to finance recurring costs. The remainder was either allotted to capital outlay programs or passed on the other governmental jurisdictions (non-recurring type expenditures). In Montana, we have devoted seventy-four percent to recurring expenditures.

As further justification to suspect the termination of revenue sharing, we refer to the current lack of success the planned special revenue sharing measures are presently having in Congress. Perhaps Congress' reluctance is because of lack of funds. On the other hand, it could be that Congress objects to the lack of strings historically attached to Federal monies passed on to other jurisdictions.

B. EMPLOYEE SALARIES

Montana has, in our opinion, made significant strides in attaining equitable, competitive salaries for State employees. A recent salary and classification survey(8) has indicated that State salaries in the clerical classes lag behind those paid by the Federal Government and are equal or slightly ahead of private industry. A survey being completed by the Salary Commission indicates, tentatively, that salaries paid to Montana's elected officials seriously lag behind those paid to comparable positions in other states and the Commission is considering a thirty-one percent increase effective as early as January 1, 1974.

Disregarding whether or not the planned increase in the salaries of elected officials is justified, the direct result is for similar percentage increases to be considered for other State employees. Without hesitation, we can unequivocally state that a general thirty-one percent pay increase in one year could not be financed from the General Fund without increasing the base of major General Fund revenue sources(9).

Generally speaking, although it seems categorically distasteful to the taxpayer, salaries paid civil servants are largely dictated by the condition of the general economy. In other words, as the cost of living increases, the salaries paid to governmental employees should be increased commensurately. If governmental salaries and wages are not increased, it is virtually impossible to attract and retain competent personnel. As the competency of the work force diminishes, the quality of governmental services decreases and, quite often, additional staff must be utilized to get the job done at an overall increase in costs.

As noted earlier, we have allowed for an overall budget increase of five percent beginning with the 1975-76 fiscal year. Accordingly, over the ensuing three year period, salaries could increase by 15.76 percent (considering the compounding effect of successive five percent increases).

Whether or not a salary increase is "automatically" provided for, salaries are likely to be increased in selected areas as the result of three main thrusts:

1. Employee Collective Bargaining Act
2. Uniform Classification and Pay Plan
3. Federal Minimum Wage Act

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(8) "Classification and Pay. Survey of Selected Clerical Classes in Montana's State Government", Department of Administration, Personnel Bureau, on January 16, 1973.

(9) From a 1973-74 base of $47.0 million, a one percent increase would cost about $500,000. A ten percent increase effective 7-1-74 would practically consume the entire amount available for recurring expenditures (See page 18).

1. Employee Collective Bargaining

The ground rules for employee collective bargaining are, at this point, far from being firm. We do not know exactly what to anticipate insofar as the effect collective bargaining will have upon wages paid to Montana state employees. If history can serve as a guideline, we can definitely anticipate continued negotiations for higher wages -- justified or not. Whether or not available revenue produced by then existing revenue sources can serve as a limiting factor in negotiating settlements is yet unknown. We would hope that it would be. On the other hand, that portion of the budget that management believes should be devoted to operating expenses and equipment could be a negotiable issue -- negotiated in an attempt to free funds for wage increases.

2. Uniform Classification and Pay

The Department of Administration, as directed by Senate Bill 411, is obligated to complete a Statewide Classification and Pay Plan. The results and recommendation of that Plan are, of course, unknown at this time. But, using the Jacob Study and the limited survey of clerical classes as a point of reference, it appears highly likely that a general salary increase will be the resultant recommendation. The price tag could be as high as $5.0 million annually. (Salary increases usually result because in adopting an "equal pay for equal work" plan, salaries are usually adjusted upward to equal, or closely equal, the prevalent salary base paid for a particular position.)

If, after formulating a Statewide Classification and Pay Plan, available funds are insufficient to provide the needed financing, total implementation must be delayed. Further, it is a possibility that, once again, the entire effort would have been substantially wasted.

3. Federal Minimum Wage Act

The Federal Minimum Wage Act has been passed by Congress. The bill applies to state workers raising their minimum salary to $1.80 upon enactment; $2.00 as of 7-1-74; and to $2.20 as of 7-1-75. The President has vetoed the Minimum Wage Act. Even so, it appears inevitable that a minimum wage will be imposed on state government within the next five years and that the amount will eventually be in the neighborhood of $2.00.

Although some full-time State employees are now paid less than $2.20 per hour, an increase to the minimum wage does not, in itself, constitute a major financial consideration. On the other hand, many employers tend to pay salaries slightly higher than the prevailing minimum wage, apparently as a technique to show their employees -- and prospective employees -- that they are trying to be fair employers. If the State were to adopt a similar attitude, the financial impact could start to be of concern. Also, a minimum wage could drive all salaries upward to maintain the range prevailent before the minimum was increased. This also would tend to have a more serious impact on General Fund finances.

C. NON-FUNDED CATEGORICAL FEDERAL PROGRAMS

With the enactment of Federal Revenue Sharing it definitely appears that categorical Federal grants previously separately funded will be discontinued or phased out over the next five years. Precisely what these programs will be and the amount involved are yet unknown. Three areas of which we are aware are the Library Services and Construction Act, Elementary and Secondary Education Act and the Social Services Program.

Whether or not Federally sponsored programs, discontinued because of Revenue Sharing, are sufficiently worthwhile to continue under State financing is a question which will soon have to be asked and answered. Without a price tag, unfortunately, there appears to be a very definite contingency here that must be acknowledged.

D. INCREASED EMPLOYER PAYROLL COSTS

Over the next five years the base of every employer payroll cost is scheduled to increase. The two notable costs are social security and retirement benefits. Also, as of January 1, 1975, all [10] State employees will be covered by State Unemployment Insurance.

		Millions Involved
1.	Social Security	$ 3.53
2.	Employee Retirement	.67
3.	Unemployment Insurance	.73
	TOTAL	$ 4.93

1. Social Security

In building the budget for the 1973-75 biennium, Social Security (F.I.C.A.) was computed based on 5.85 percent with a $10,800 earning base in the 1973-74 fiscal year and $12,000 earning base for the 1974-75 fiscal year. Contacts with local Social Security Administration officials indicate that the cost of Social Security will increase over the years but the exact increase cannot be predicted precisely. Although the percentage rate is fixed through 1979, the earning base is variable depending on a cost of living index which is used to periodically adjust Social Security benefits.

As of this date, the following schedule appears likely:

Effective	Percentage	Earning Base
1-1-74	5.85	$ 12,600
1-1-75	5.85	13,500
1-1-76	5.85	13,500
1-1-77	5.85	15,000
1-1-78	6.05	15,000
1-1-79	6.05	15,000

The impact of these increases on the General Fund depends largely upon individual wages paid. Salaries of individuals paid from the General Fund can be ascertained but not without considerable, time-consuming effort. We will, as time permits, develop a data base which will enable us to better predict the impact of related spending plans. For now, however, we have assumed that General Fund salaries constitute sixty percent of the total General Fund appropriations excluding the Foundation Program and employer payroll costs. This assumption yields the following General Fund salary information.

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(10) SB 427, page 6. Employees of the University System and the three State hospitals have been covered since January 1, 1972.

Fiscal Year	Projected Payroll Millions	Increased[11] Social Security Tax
1974-75	$ 49.4	$ 287,400
1975-76	51.8	574,000
1976-77	54.4	796,300
1977-78	57.1	1,023,500
1978-79	60.0	1,138,650
SIX YEAR TOTAL		$ 3,819,850
SUPPLEMENTAL FINANCING[12]		3,532,450

2. **Employee Retirement**

The employer's share of the employees' retirement plan has been budgeted at 4.9 percent on total wages. As of July 1, 1975, the employer's contribution will increase to 5.2 percent. This increase prices out as follows:

Fiscal Year Fiscal Year	Salary Base in Millions	Additional Amount
1975-76	$ 51.8	$ 155,000
1976-77	54.4	163,000
1977-78	57.1	171,000
1978-79	60.0	180,000
TOTAL		$ 669,000

At the time the 5.2 percent rate was negotiated, pressures were prevalent to increase the employer's share even further. Whether or not any further increases will be approved is, of course, unknown at this time but an increase to 5.75 percent as of 7-1-77 will more than likely be the subject of future negotiations.

3. **Unemployment Insurance**

The unemployment insurance rate, an employer payroll cost, will probably be .4 percent initially with upward or downward adjustments made as claim experience dictates. The added cost of unemployment insurance is estimated on the following page:

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(11) These figures take into consideration that some salaries are beyond the applicable salary ceiling and social security tax does not apply. We have assumed that about 85 percent of salaries paid are subject to this withholding.

(12) Assumes that the agencies will be required to finance the extra $287,400 from existing appropriations.

	------------------ MILLIONS OF DOLLARS ------------			
Fiscal Year	Total Est. Salaries	Less: Univ/ Hospital** (Est.)	Net	Cost @ .004
1974-75	$ 49.4	$ 12.4	$ 37.0	$ 74,000*
1975-76	51.8	13.6	38.2	152,800
1976-77	54.4	14.3	40.1	160,400
1977-78	57.1	15.0	42.1	168,400
1978-79	60.0	15.7	44.3	177,200
			TOTAL	$ 732,800

* ½ of $148,000

** See Footenote (10)

4. CASH BASIS BUILDING PROGRAM

The $16.4 million Long-Range Building Program authorized for the 1973-75 biennium is now funded on a cash basis.

If the building program is to continue at a rate of around $11.0 million per biennium, provision must be made to provide needed financing. If we are to continue to operate a cash basis building program, over the next two bienniums as much as $11.0 million in cash financing must be provided in addition to the $11.0 million to be derived from cigarette tax money.

Unless a new source of revenue is provided, this financial load would have to be borne by the General Fund.

ASSUMING THAT THE PROJECTED SURPLUSES ARE ACCURATE AND THE IDENTIFIED CONTINGENCIES ARE REALISTIC, HOW MUCH MONEY IS AVAILABLE FOR APPROPRIATION AS OF JANUARY 1, 1974?

Before answering the question, a few basic assumptions are necessary:

1. Federal Revenue Sharing will be continued beyond the present 12-31-76 termination date providing at least $7.25 million annually to the State. Also, all revenue sharing monies now available will be used for recurring expenditures.

2. Additional interest will be produced by retaining the surplus as indicated. The $1.0 million annual addition recognizes that annual revenue estimates already consider some portion of interest earnings from surplus monies available in fiscal year 1973.

3. The price tag of additional salaries is conservatively estimated at $3.0 million.

	73-74	74-75	75-76	76-77	77-78	78-79
Surplus Brought Forward	$18.20	$21.30	$27.00	$21.87	$16.50	$10.90
Surplus Contribution	2.10	4.70				
Additional Interest	1.00	1.00	1.00	1.00	1.00	
Available Surplus	$21.30	$27.00	$28.00	$22.87	$17.50	$10.90
DEDUCTIONS						
1. Additional funding resulting from diminishing Revenue Sharing monies			2.25	2.25	2.25	2.25
2. Added employee salaries			3.00	3.00	3.00	3.00
3. Increased payroll costs:						
a. Social Securities			.57	.80	1.02	1.14
b. Employee Retirement			.16	.16	.17	.18
c. Unemployment Insurance			.15	.16	.17	.18
ADJUSTED SURPLUS	$21.30	$27.00	$21.87	$16.50	$10.90	$ 4.15

With $4.15 million available at June 30, 1979, recurring expenditure plans adopted as of January 1, 1974 should not exceed $1.0 million if funding through 1979 is to be assured.

IN CONCLUSION, WHAT ACTION SHOULD BE TAKEN WITH REGARD TO THE GENERAL FUND'S FINANCIAL CONDITION AND WHY?

Generally, we recommend that a cautious attitude toward General Fund surpluses be adopted and enforced until such time as variable and unpredictable National and State economic trends stabilize. Although we would favor a plan that holds virtually intact the accumulated surplus through January 1, 1975, we realize that this is likely not to be a palatable plan. If a disposition, or partial disposition plan, is to be considered during the 1974 Legislative Session, we strongly urge the Governor to adopt the following alternative plans regarding the General Fund's financial condition.

RECOMMENDATION 1 – CONTINGENCY RESERVE

Provide that $10.0 million of the present General Fund surplus be set aside as a contingency reserve. This amount is to be used in future years only after all reasonable alternatives have been exhausted. Drawdowns should be replenished as soon as possible, up to the $10.0 million level, providing that to do so does not necessitate an increase in the base of existing major General Fund revenue sources.

WHY? As discussed in detail in earlier portions of the report, there are many financial contingencies facing Montana in future years. We do not yet know the exact financial impact of these contingencies. A reserve of $10.0 million should provide for these contingencies without imposing additional revenue sources or an increase in existing revenue sources and provide a healthy base for investment purposes ($10.0 million could produce $5.7 million in interest over the next five years at 8 percent compounded semi-annually).

Providing that the reserve account be replenished whenever possible will provide funds for contingencies that lie beyond those satisfied by justified drawdowns.

RECOMMENDATION 2 – MAINTAIN EXISTING REVENUE BASE

Provide for the maintenance of current General Fund revenue sources.

WHY? Under the circumstances, and until the economic climate stabilizes, we cannot recommend a reduction in the tax base of any General Fund major revenue source. More than likely, however, pressures will be prevalent to further reduce the income surtax.

In round numbers, each one percent reduction in the income surtax reduces total revenue by $750,000 annually with the following impact on State accounts:

State Account	%	Annual Reduction Per Percent	10 Percent Reduction
General Fund	64	$480,000	$4,800,000
Public School Equalization	25	187,500	1,875,000
LRBP Sinking	11	82,500	825,000
TOTALS		$750,000	$7,500,000

According to our projections, an annual decrease of General Fund revenues resulting from the elimination of the income surtax would virtually consume the three-year surplus by June 30, 1979 ($4.8 of an available $5.0) without allowing any reserves or any contingencies to be satisfied.

In addition to the direct effect on the General Fund, consideration must be given to the impact on the other two accounts involved.

During the 1973-75 biennium ". . .all amounts available. . ." in the Public School Equalization Account are to be distributed to the school districts. Consequently, the State has no formal obligation to distribute any particular amount. The Governor's Budget, on the other hand, recommends appropriations of $19.4 and $21.1 million in each fiscal year of the biennium. We are using these figures for financial planning purposes.

Presently, assuming no reduction in the income surtax, the Public School Equalization Account should be able to distribute $40.5 million to the school districts during the 73-75 biennium. If the surtax is reduced, the amount available for distribution is reduced also. Depending on the percentage of the reduction, it might be necessary to assess an emergency mill levy to make up the resulting difference.

The impact on the Long-Range Building Program Sinking Account is relatively minimal. However, a reduction here tends to reduce the amount of Long-Range Bond Excess that flows into the General Fund.

RECOMMENDATION 3 – CONSIDER LIMITED BUDGET SUPPLEMENTS

Provide for supplements to the General Fund operating budget, beginning with the 1973-74 fiscal year, wherein proven inadequacies are prevalent or added efforts will produce highly desirable results.

WHY? We hope that we have previously established the fact that inflationary pressures have created some difficulties with the 1973-75 budget plan as enacted. Also, some desirable service programs undoubtedly lack funding or were provided marginal funding in the 1973-75 budget.

Considering the contingencies identified herein and the projected surpluses, we recommend that supplementals for recurring expenditures be limited to no more than $1.0 million.